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RUEHKH/AMEMBASSY KHARTOUM 1710
RUEHLGB/AMEMBASSY KIGALI 4996
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SIPDIS

STATE FOR AF/E, AF/EPS, AND AF/RSA

STATE PASS TO USTR FOR BILL JACKSON

TREASURY FOR VIRGINIA BRANDON

SENSITIVE

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SUBJECT: KENYA SHILLING'S RISE AGAINST DOLLAR A TWO-EDGED SWORD

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Summary

¶1. (SBU) The Kenya shilling has appreciated 12.3% against the U.S. dollar this year, from Ksh69.55 on January 1 to Ksh61 on November ¶27. Kenya is highly dependent on dollar-denominated horticultural, tea, and tourism export earnings. Frightened exporters are intensifying their pressure on the Central Bank of Kenya (CBK) to help them, but the CBK attributes much of the shilling's strength to the dollar's global weakness and the flow of foreign investment into Kenya, and it has no intention to intervene. Kenya runs a large merchandise trade deficit, so importers should benefit. Exporters stand to lose despite savings on their imported inputs. They may try to make the shilling's appreciation into an election campaign, but it is unlikely the CBK will take action to support the dollar out of fear that doing so would fuel inflation. End summary.

Shilling on a Rapid Recent Rise

¶2. (SBU) After appreciating slowly from Ksh69.9 to the dollar in January 2007 to Ksh67.0 in October, the shilling suddenly zoomed to Ksh60.5 against the dollar on November 28, its highest level in eight years. CBK Governor Njuguna Ndung'u citedthe weakening of the dollar in international markets as a major cause of the stronger shilling locally. Dealers cited low demand for the U.S. currency from corporate clients as banks unwound their dollar positions. Ndung'u noted that the situation has forced Kuwait and the United Arab Emirates to abandon the dollar as a reserve currency, while South and East African investors and central banks are putting less of their money into the dollar. Dr. David Ndii, a leading Kenyan consultant, economist, and scholar, concurred with the CBK governor that the decline of the U.S. dollar has little to do with the Kenyan shilling, but is caused by other global factors.

¶3. (U) The shilling has not experienced similar appreciation against

the currencies of its major trading partners. From January to November 2007, the shilling depreciated 3.9% against the Euro, from Ksh91.4 to Ksh94.9. The shilling appreciated by 3% against the UK pound in the first nine months of 2007. During the same period, the Ugandan shilling depreciated 5% against the Kenya shilling, and the Tanzania shilling appreciated 1%.

Cashing in at Home

¶4. (U) The CBK Governor's analysis aside, local conditions have also contributed to shilling strength and dollar weakness. Kenya is enjoying hefty inflows of greenbacks due to improved foreign export earnings, a booming tourism sector, and foreign participation in the privatization of leading parastatals. An estimated Ksh60 billion (over $980 million), some of it in dollars, is expected to flood the local financial market following the recent investments by foreign companies in Equity Bank and Telkom Kenya, and the upcoming sale of shares in Safaricom, the country's largest mobile phone company through an initial public offer (IPO). With these massive dollar inflows expected towards the end of the year, market players are predicting further shilling appreciation against the dollar.

¶5. (U) International organizations operating in the conflict areas of the region -- Southern Sudan, Somalia, Burundi and Democratic Republic of Congo (DRC) -- are also keeping all their dollars in Kenyan banks. Jaindi Kisero, managing editor of the EastAfrican weekly newspaper, claimed they have created an unprecedented regional demand for the shilling. Kisero added that Nairobi's Eastleigh Estate has become an informal hub for remittances by the Somalia diaspora, transmitting millions of dollars every day from Europe, Canada and the U.S. to Mogadishu. However, there is no analytical work on the impact of these informal inflows on the shilling's rise.

While Exporters Fear Crashing Out

¶6. (U) Some Kenyans recognize the strong shilling will cut Kenya's import bill for capital goods and crude oil, and ease foreign debt repayment. Others worry that the shilling's precipitous rise will impact negatively on companies which earn their revenue in dollars and other international currencies. They believe the drop in the dollar is bound to affect the earnings of a number of listed firms, and could even lead to job losses. These companies have seen their share prices fall on the Nairobi Stock Exchange. Kenya's national airline, Kenya Airways, recently revealed that its revenues declined by Ksh728 million (over $11.7 million at current exchange rate of Ksh61) between September 2006 and September 2007 as a result of the shilling's appreciation. The airline earns most of its revenues in foreign currency. A property consulting firm estimated that 10%-20% of Kenyan property leases are denominated in dollars, some at a fixed rate. The firm estimated that some property owners have already suffered a 10%-15% drop in rental earnings from the shilling's appreciation, especially for offices, shopping malls and retail outlets, whose property lease terms are irrevocable for six years.

¶7. (U) CBK itself took a Ksh9.3 billion ($129 million) foreign exchange loss on its official reserves in the fiscal year ending June 31, 2007. Official foreign exchange reserves of $2.82 billion were worth Ksh182.5 billion at the end of September. When the shilling peaked at 60.35/USD on November 27, the value of reserves dropped to Ksh170.2 billion. The book loss of Ksh18.3 billion means that CBK will not be able to pay a dividend to Treasury. Over the past year, the CBK has accumulated usable official reserves of $2.8 billion as of July 2007, equivalent to at least 4.4 months of import cover.

¶8. (U) Tiku Shah, the chairman of the Fresh Produce Exporters Association of Kenya, contends that the gain in the Kenya shilling has thrown the local exporting sector into jeopardy. A strong shilling erodes local earnings from horticultural, tea, coffee and other agricultural exports, which account for 49.8% of the total domestic export earnings in 2006. His counterparts in the tourist industry are equally alarmed. Kenya's tourism sector has witnessed

tremendous growth, earning the country about $803 million in 2006. The number of American visitors grew 17.6% in 2006 to 86,528, making the U.S. Kenya's second largest source of visitors. The strong growth continued in the first three quarters of 2007, and the Tourism Board reported that Americans are, on average, the highest spending visitors to Kenya. However, a weak dollar may dampen earnings for industry players. According to Kenya Association of Hotelkeepers and Caterers Coast branch chairman Mohamed Hersi, big hotels in the country could lose about Ksh30 million (about $492,000) if the shilling continues to gain against the dollar. He claimed tourist hotels that signed contracts with travel agents when the dollar was at Ksh66 stand to lose 30% of their revenue.

Reprieve for Importers for now

¶9. (U) Importers are having an easier time as their dollar-denominated import commodities are coming in more cheaply. With rising energy and capital goods import bills, the stronger shilling is expected to slow down inflation generated by high crude oil prices. According to its Economic Survey 2007, Kenya in 2006 imported goods worth Ksh521 billion (over $7.2 billion) compared to Ksh228 billion (over $3.0 billion) in 2005. Kenya would save about $1.3 billion for a similar import bill in 2007 if the current exchange rate is sustained.

Analysis

¶10. The shilling's appreciation against the dollar hurts agricultural exporters, favors urban consumers, and has a mixed effect on industrial firms depending on a company's export orientation. Exporters who earn dollar revenues will feel the squeeze as the shilling value of their earnings falls, and the dollar cost of their labor and local inputs rises. Those that import their inputs for dollars but earn shilling revenues will conversely benefit. Horticulture, tea, and coffee exporters face a choice: Reduce their local costs, including their staff and/or the wage bill, or ask their largely European customers to switch to Euro-denominated payments. Importers in COMESA, Kenya's biggest export market, are unlikely to be able to switch to Euro payments. Exporters within the country's Export Processing Zones (EPZs), whose high costs of production already hurt their competitiveness, may leave. AGOA garment exporters may be especially vulnerable. They import most of their inputs from Asia and pay in dollars. If their Asian suppliers raise their prices to protect their local currency profits from the dollar's depreciation, it would further reduce Kenya's competitiveness against Asian garment producers.

Comment

¶11. (SBU) If shilling stays in the Ksh60/dollar range or appreciates even further, companies whose revenues are largely denominated in dollars will face a grim fourth quarter. Few Kenyans appear to be thrilled about their shilling's newfound muscle. The CBK will face continued pressure from exporters to establish some special exchange rate program, or to buy more dollars. This would be problematic, however, because it would expand money supply precisely at a time the CBK is trying to restrain money growth as way to control inflation, which remains stubbornly high. Thus, even if the shilling's appreciation becomes an election campaign issue, we doubt very much the CBK will take action to support the dollar at this time.

Ranneberger